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SUBJECT: FOREIGN DIRECTORS OF CHINESE BANKS HELPING TO
IMPROVE GOVERNANCE

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11. (SBU) Summary: During a lunch on April 19 lunch with analysts from the New York Federal Reserve Bank, three foreign directors of four Chinese banks (Minsheng Bank, China Everbright Bank, Bank of Beijing and Xi'an City Commercial Bank) shared their experiences. On the question of governance, they all highlighted the continued control of the Communist Party over key decisions such as bank leadership, but were upbeat on their assessment of improving governance standards. Developing a credit culture remains a major challenge, especially since China still lacks an effective legal system and credit information bureaus. Still, all of the directors agreed that foreign directors are having a positive impact and that the Chinese leadership supports foreign participation in Chinese banks. End summary.

12. (U) On April 19, a delegation of analysts from the New York FRB met with three foreign directors who sit on the boards of several Chinese banks: Jim Stent of Minsheng Bank, Frank Hawke of China Everbright Bank, and Michael Ipson, banking specialist from the International Finance Corporation (IFC) Beijing rep office, who represents IFC on the boards of the Bank of Beijing and the Xi'an City Commercial Bank.

Party Influence

13. (SBU) One of the issues complicating the reform of Chinese banks is the continued influence of the Communist Party on management decisions. Despite this, Ipson of IFC believes that the banks have actually made progress in improving corporate governance. He reported that the Party Secretary of one of his banks has even praised IFC's role

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in improving governance standards. Stent of Minsheng agreed, saying his bank generally wants to reach international standards, but it is a difficult process, as Chinese companies have had boards of directors for less than 20 years. He stated that the Party appoints the Chairman and President of every bank, with nominations going to the Party Secretary at the China Banking Regulatory Commission for approval. Because of this, Hawke

said his bank has changed the name of the "Nomination Committee" to the "Human Resource Subcommittee."

¶4. (SBU) Regarding the Party's influence over credit allocation decisions, Hawke averred that the Party has not been making these decisions at Everbright Bank, but joked that given the bank's poor track record, even the Party could have done a better job. In his view, the Government's biggest quandary for the state-owned banks is how to get them to act like Western banks without losing control. Hawke expressed pessimism that the banks will succeed, predicting that the banks will need to be recapitalized again at some point in the future.

No Credit Culture

¶5. (SBU) Stent said one of the biggest challenges is the lack of a real credit culture. In the past, they were simply arms of the Ministry of Finance, and even now they are not used to the credit culture concept. The Minsheng Bank has only existed for ten years and only has experience with a growing economy. Although Minsheng's NPL ratio is under 2 percent, the ratio could go up if the economy falters and companies begin to fail. Banks continue to favor lending to state-owned enterprises and to state-sponsored projects because the state stands behind them. Eventually the banks will have to start doing a "means and purpose test" for loans. Ipson commented that the banks will continue lending to SOEs because they are the lowest risk borrowers. From the Everbright bank experience, Hawke pointed out that "before you build, you have to put out the fire." Before Everbright could change its lending policies, it had to first "staunch the bleeding." To do this, he said the bank headquarters withdrew all credit authority from the local levels. In his view, it is necessary to separate the credit and marketing functions.

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Stent noted that there has been some debate about this issue. When he was at the Bank of Asia in Thailand, credit authority was taken away from the branches and the branch managers became sales managers instead. This, of course, required a very responsive credit function at the head office, which would not be true in Chinese banks.

¶6. (SBU) All three directors agreed that building a credit culture is a slow process. Stent noted that it takes a great deal of training at all levels, with a total commitment from the senior management. To assist in this effort, Ipson pointed out that the IFC is helping the People's Bank of China develop a credit information bureau. Even a state-owned entity like this is a step forward, although it will take a long time to sort out the legal system to support it. He noted that China has more of a "rule of judges" rather than "rule of law." Hawke pointed out that one major legal problem for banks is that a bank legally cannot foreclose on a borrower's primary residence.

Foreign Director Effect

¶6. (SBU) The directors all agreed that they are having a positive influence in the way their bank boards operate. Hawke said he had succeeded in ratcheting back Everbright's lending targets for 2006. Despite Everbright's negative capital position, Hawke said his bank originally aimed at growing its loan portfolio by 12 percent in 2006. Hawke countered with an 8 percent proposal, and eventually persuaded the bank to adopt a lower target. He noted that Chinese bank boards will usually put off a vote if it appears there will be a dissenting vote because dissenting votes have to be reported to the China Banking Regulatory Commission (CBRC). Stent pointed out that the standard is even higher for listed banks like Minsheng: dissenting votes have to be made public. In his bank, if an issue

will not receive unanimous support, it will be pulled. He commented to Hawke that it was impressive that Everbright's board discussed the loan growth issue so openly. Hawke suggested that despite Everbright's bad loan problem, it actually has a reputation for better-than-average management. Perhaps this is because the ADB, the first foreign investor to take a stake in a Chinese bank, has been working with Everbright since 1997. The three directors agreed that Everbright and China Merchants at least had the best reputations for customer service. Ipson commented that the banks still need to develop more income options because thus far over 90 percent of bank income is generated from interest on loans. Stent commented that the banks are not yet using their ability to charge higher interest for higher risk.

¶7. (SBU) Although foreign investors are helping to reform the banking system, Stent commented that there has been a backlash against foreign investment in the banks. As a result, he suggested the senior leadership may slow the reform process. Ipson argued that China's leadership still expects foreign participation in the banking sector will make a major difference. Hawke agreed, noting that the Chinese Government is very concerned that the continued misallocation of capital will eventually affect growth. China is looking to foreign investors to help it improve the overall management of the banking sector.

¶8. (U) Report was cleared by the New York FRB delegation.

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